Office of the Special Inspector General for Pandemic Recovery

Lessons Learned: Recognizing Structural Aspects of the Main Street Lending Program that Failed to Prevent Fraud

February 23, 2024

Introduction

In this report, the Special Inspector General for Pandemic Recovery (SIGPR) focuses on certain aspects of the Main Street Lending Program (MSLP) that failed to prevent fraud by borrowers. Loans that were extended under the Main Street Lending Program (MSLP) under the CARES Act during the second half of 2020 and early 2021 required no payment of interest during their first year, and no payment of principal until the third of the five-year term of the loan. As those loans have entered their third year—during which borrowers must pay not only interest but also 15 percent of the principal—the rate of defaults and impairments for nonpayment has spiked sharply. It is certainly the case that not all of the borrowers in default committed loan fraud. But the significantly elevated level of defaults reflects a tradeoff embedded in the structure of the Main Street Lending Program between ensuring the creditworthiness of borrowers and making the MSLP loans attractive to lending banks.

The Special Purpose Vehicle (SPV) managed by the Federal Reserve Bank of Boston (FRBB) purchased participation in all but 5 percent of each loan, and thereby left lending banks with very little exposure in the event of a default. For this reason, and because the program purposefully required lending banks to conduct only minimal due diligence, the Main Street Lending Program created circumstances in which lending banks had insufficient incentive to vet their borrowers sufficiently to prevent fraud.

In saying this, SIGPR fully recognizes that the Federal Reserve Board of Governors consciously chose to structure the program to prioritize facilitating access to credit in the U.S. economy, and knowingly accepted that this could create an increased risk of higher levels of fraud. SIGPR issues this “lessons learned” report on this issue solely for the purpose of fully highlighting for Congress and the general public the trade-offs involved in the choices that were made, so that they can make well-informed choices in the future. This is the first of a series of reports that SIGPR intends to issue reflecting “lessons learned.”

Background on the Main Street Lending Program

In March 2020, Congress approved the Coronavirus Aid, Relief, and Economic Security (CARES) Act to provide over $2 trillion to individuals and businesses negatively affected by the coronavirus disease 2019 (COVID-19).[1] Section 4003 of the CARES Act provided $454 billion to the Department of the Treasury to make loans, loan guarantees, and other investments in “programs or facilities established by the Board of Governors of the Federal Reserve System for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, States, or municipalities.”[2]

The CARES Act also directed the Treasury Secretary and the Federal Reserve Board of Governors (the “Board”) to work in conjunction to establish lending facilities. The Secretary was to “endeavor to seek implementation of a program or facility . . . that

[1] Pub. L. No. 116-136, 134 Stat. 281 (2020).

[2] *Id.* at § 4003 *codified at* 15 U.S.C. § 9042.

supports lending to eligible businesses, States, or municipalities."[3] The Board was to implement these facilities using the Federal Reserve's emergency lending authority under Section 13(3) of the Federal Reserve Act, 12 U.S.C. § 343(3). Since the amendments effected under the Dodd-Frank Act, the Board can only create a section 13(3) facility with "prior approval" from the Treasury Secretary.[4]

With the Secretary's approval, the Board established the Main Street Lending Program ("MSLP"), which was comprised of five facilities. These facilities provided credit to small and medium for-profit businesses and nonprofit organizations that were financially sound before the COVID-19 pandemic.[5] Three of these facilities were available to for-profit businesses: the Main Street New Loan Facility (MSNLF), the Main Street Priority Loan Facility (MSPLF), and the Main Street Expanded Loan Facility (MSELF). All three facilities used the same "eligible lender" and "eligible borrower" criteria, and had many of the same features, including the same maturity, interest rate, deferral of principal for two years, deferral of interest for one year, and the ability of the borrower to prepay without penalty. Other features of the loans extended in connection with each facility differed, and the loan types also differed in how they interacted with the eligible borrower's existing outstanding debt, including with respect to the borrower's level of pre-pandemic indebtedness. The other two facilities were available to nonprofit organizations and are not relevant for our purposes here. A set of Frequently Asked Questions was posted to the websites of the Board and the Federal Reserve Bank of Boston that provided more detailed information about the program.[6]

General Structure of Main Street Loans

Main Street loans were to be originated by private banks but, to fulfill its purpose of increasing access to credit, a special purpose vehicle ("SPV") purchased 95 percent participation in each loan. The SPV (MS Facilities LLC) is managed by FRBB. The funds that were to be used to purchase the 95 percent participations in these loans were to come from the Board's emergency lending facility under Section 13(3) of the Federal Reserve Act. The Treasury Department was the preferred equity member of the SPV and agreed to provide it with $75,000,000,000 in funding to be used only in the event of losses ultimately suffered by the SPV.

Loans that had the following features were eligible for participation by the SPV:

- 5-year maturity.
- Adjustable interest rate of LIBOR (1 or 3 month) plus 300 basis points (that is, plus three percent).[7]

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[3] Id.
[4] Id.
[5] Id.
[6] *See* https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm for links to various versions of the FAQs, which were periodically updated during the initial phases of the program.
[7] The U.S. LIBOR was decommissioned as of June 30, 2023. According to FRBB officials, 96 percent of Main Street loans have transitioned from a LIBOR-pegged rate to the Secured Overnight Financing Rate (SOFR), and the remaining 4 percent transitioned to other comparable rates (such as the prime rate).

- Interest payments deferred for one year (with unpaid interest capitalized).
- Principal payments deferred for two years.
- Principal amortization of 15 percent at the end of the third year, 15 percent at the end of the fourth year, and a balloon payment of 70 percent at maturity at the end of the fifth year.
- Minimum loan size of $100,000.
- Subject to a maximum loan size that varied according to which type of loan was extended, the size of the loan was limited to an amount that, when added to the eligible borrower's existing outstanding and undrawn available debt, does not exceed certain multiples of the eligible borrower's adjusted 2019 earnings before interest, taxes, depreciation, and amortization ("EBITDA").[8]
- Prepayment permitted without penalty.[9]

As a practical matter, because payment of principal was deferred for two years, and was then backloaded (for example, 15 percent in each of the third and fourth years, and 70 percent in the fifth and final year), there were few defaults on Main Street loans during the first year of the program, but the level of defaults has been sharply rising since interest payments and then principal payments were first due in the second and third years of the program, respectively.

Certifications Required for Main Street Loans

For a loan to be eligible for the Main Street program—and, in particular, for a commitment by the SPV to purchase its 95 percent participation—the lender and borrower were also required to execute standard certifications.[10] The instructions for both sets of certifications specifically state that, "[f]or purposes of these certifications and covenants, the Federal Reserve's current Frequently Asked Questions ("FAQs") on the Main Street Facilities, as posted on the website of the Board or the Reserve Bank as of the date hereof are incorporated by reference." The instructions further noted that the borrower and the lender "may rely on the clarifications and interpretations provided in the FAQs, to the extent applicable."

(*See* "Federal Reserve Lending Programs: Status of Monitoring and Main Street Lending Program," at 32 n.38 (United States Government Accountability Office, December 2023) (available at https://www.gao.gov/assets/d24106482.pdf).

[8] The methodology used by the lender to calculate adjusted 2019 EBITDA was required to be the methodology that it had previously used for adjusting EBITDA when extending credit to the borrower or to similarly situated borrowers on or before April 24, 2020.

[9] Main Street New Loan Facility Lender Transaction Specific Certifications and Covenants Instructions and Guidance, available at https://www.bostonfed.org/supervision-and-regulation/credit/special-facilities/main-street-lending-program/docs.aspx, at 2-5.

[10] Versions of those certifications, along with the instructions that accompanied them are available at https://www.bostonfed.org/supervision-and-regulation/credit/special-facilities/main-street-lending-program/docs.aspx.

Borrower Certification Regarding Ineligible Businesses

The certifications that the borrower was obligated to execute[11] included the following:

Not an Ineligible Business. The Borrower must certify that, after reasonable, good faith diligence, it has no reason to believe it is an Ineligible Business.

- For purposes of the Borrower Certifications and Covenants, an "Ineligible Business" means a business of any of the types listed in 13 CFR 120.110(b)-(j), (m)-(s), as modified and clarified by Small Business Administration ("SBA") regulations for purposes of the Paycheck Protection Program ("PPP") on or before April 24, 2020. Such modifications and clarifications include the SBA's recent interim final rules available at 85 Fed. Reg. 20811, 85 Fed. Reg. 21747, and 85 Fed. Reg. 23450. The Federal Reserve may further modify the application of these restrictions to Main Street.
- *Reasonable Good Faith Diligence*. For purposes of this certification, Eligible Borrowers are expected to review the list of Ineligible Businesses in 13 CFR 120.110(b)-(j), (m)-(s), and make a reasonable, good faith effort to determine if the Borrower's activities or ownership would cause it to be classified within one of the listed ineligible categories. If representatives of the Borrower have reason to believe that the Borrower may be an Ineligible Business under the categories listed in that regulation, Borrowers are expected to conduct further inquiry into the SBA's interpretations of such categories, including in the interim final rules, and to reference the FAQs.

The referenced regulation (13 CFR § 120.110) is part of the rules usually applied to SBA loan programs.

Lender Certifications

Like the borrower, the lender for a Main Street loan was required to have an authorized officer or representative of the lender execute a set of standard certifications.

Lenders were required to certify that the terms of its loan to the borrower conformed with the standard terms required for the 95 percent participation by the SPV. With respect to the ***borrower's*** certifications that it was a business and that it was established prior to March 13, 2020, the lender was required to make "Due Inquiry with Respect to Formation"— defined as receipt of supporting documentation from the borrower certified by the appropriate governmental authority and having taken "those steps to verify such formation as are required under the Lender's ordinary underwriting policies and procedures."

With respect to all other aspects of the borrower's certifications—including the certification regarding ineligible businesses—the lender was only obligated to "certify that each borrower has delivered to the Lender its own Borrower Certifications and Covenants, signed by the persons identified as the signatories thereof." The instructions make clear that lenders had no obligation to investigate the accuracy of the

[11] The certifications were required to be executed by the borrower's principle executive officer and principal financial officer "or individuals performing similar functions."

certifications (other than those relating to formation). The instructions specifically provide that, in certifying its receipt of the borrower's certifications, "the Lender assumes no responsibility for verifying the accuracy of such Borrower Certifications and may rely entirely on the Borrower's certifications…." The lender was not obligated to monitor the borrower's ongoing compliance with its covenants but was "expected to promptly notify the SPV and the Reserve Bank if the Lender becomes aware of a Borrower's material breach of such covenants as a result of the Borrower self-reporting." The purpose of these instructions appears to have been to make clear that the lending institution was not required to conduct due diligence with respect to the borrower's certifications. The instructions do not specify what, if any, notification obligation a lender had if it discovered a borrower's noncompliance by means other than the borrower's self-reporting. Nevertheless, the FAQs specifically state that, "[i]f an Eligible Lender becomes aware that an Eligible Borrower made a material misstatement or otherwise breached a covenant during the term of an MSNLF Loan, MSPLF Loan, or MSELF Upsized Tranche, the Eligible Lender should notify the FRB Boston."

The FAQs noted that lenders were responsible for determining the creditworthiness of a borrower, and that the eligibility of a borrower (in terms of the eligibility rules in the SBA regulations) did not necessarily mean that a borrower would be granted a loan. Lenders, the FAQs noted, "are expected to conduct an assessment of each potential borrower's financial condition at the time of the potential borrower's application." In doing so, lenders were to "apply their own underwriting standards in evaluating the financial condition and creditworthiness of a potential borrower" and could "require additional information and documentation in making this evaluation." As set forth in FAQ F.3, it was the bank—and not the Board or the SPV—that "[would] ultimately determine whether an Eligible Borrower is approved for a Program loan in light of these considerations."

Fees Associated with Main Street Loans

There were three types of fees associated with the origination of MSNLF, MSPLF and MSELF loans.

First, lenders paid the SPV a transaction fee at the time of origination and were permitted to pass this fee on to borrowers. For MSNLF and MSPLF loans, if the initial principal amount of the loan was $250,000 or greater, the lender paid the SPV a transaction fee of 100 basis points (that is, one percent) of the principal amount of the loan. If MSNLF or MSPLF loans were less than $250,000, there was no transaction fee to be paid. The transaction fee for MSELF loans was always 75 basis points (that is, three-quarters of a percent) of the principal amount of the MSELF Upsized Tranche.

Second, borrowers also paid a loan origination fee to lenders (though lenders had discretion over whether and when to charge borrowers this fee). For MSNLF or MSPLF loans of $250,000 or greater, the borrower paid the lender a fee of up to 100 basis points (that is, one percent) of the principal amount of the loan at the time of origination. For MSNLF or MSPLF loans of less than $250,000, the borrower paid a loan origination fee of up to 200 basis points (that is, two percent). For MSELF loans, the loan origination fee was up to 75 basis points (that is, three-quarters of a percent) of the principal amount of the loan at the time of upsizing.

Third, the SPV paid lenders a fee each year for loan servicing. For MSNLF or MSPLF loans of $250,000 or more, the loan servicing fee was 25 basis points (that is, a quarter of a percent) of the principal amount of the SPV's participation. If the initial principal amount of MSNLF or MSPLF loans were less than $250,000, the loan servicing fee was 50 basis points (that is, a half of a percent) of the principal amount of its participation each year. The loan servicing fee for all MSELF loans was 25 basis points (that is, a quarter of a percent) of the principal amount of the SPV's participation.

Fee income that a lender could receive for Main Street loans could be significant. For example, for an MSNLF loan of $25 million, the loan origination fee that the lender would receive would be up to $250,000, and the lender would receive $296,875 in loan servicing fees (the total amount equal to 0.25 percent of the SPV's 95 percent participation ($23,750,000) for each of 5 years).

Current Level of Defaults and Charge-offs in the Main Street Lending Program

As part of SIGPR's assessment of how the structure of the Main Street Lending Program increased the risk of fraudulent borrowing, SIGPR reviewed the SPV's "loan loss allowance"—the "estimate of uncollectible amounts used to reduce the book value of loans…to the amount that" the SPV expects to collect, as well as the "actual credit losses" that the SPV has reported up through the point at which MSLP borrowers were required to make their first payments of principal. SIGPR compared those loss levels to those that banks with similarly sized non-MSLP loan portfolios have sustained and found that the MSLP losses were substantially larger.

In February 2021, after the last of the MSLP loans had been made, the SPV reported that the total principal outstanding in the Main Street Lending Program at the end of January 2021 was $16,448,448,031.[12] In March 2021, the SPV reported a loan loss allowance of $2,400,000,000, which was equal to 14.6 percent of the outstanding principal.

By the end of 2022, due primarily (if not completely) to early repayment of some loans, the outstanding principal had decreased to $10,409,503,261. In January 2023, the SPV reported to Congress that its loan loss allowance stood at $1,400,000,000, which is equal to 8.5 percent of the original outstanding principal.

Calendar year 2023, however, was the period during which the first principal payments (of 15 percent) became due on MSLP loans. As of January 2024, the SPV reported total principal outstanding of $7,313,165,772, and a loan loss allowance of $820,000,000. This loan loss allowance represented 4.9 percent of the original outstanding principal.

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[12] The data about principal outstanding, loan loss allowances and actual losses that is included in this section of SIGPR's report was obtained from the Periodic Report that the SPV sends to Congress each month and from audited financial reports of the SPV issued annually by KPMG. Charts setting forth some of this data are attached to this report as Appendix A.

The level of actual losses that the SPV reported is even more telling about the trend line after borrowers became obligated to repay a portion of the principal. As of the end of August 2022 (before any principal payments were due because it was before any loans reached Year 3), the SPV reported actual losses of $42,000,000. By the end of 2022, reported actual losses jumped to a total of $95,000,000. And by the end of 2023, total actual losses spiked up to $564,000,000. These figures reveal that the SPV's actual losses just during calendar year 2023 amounted to $469,000,000.

The significance of the percentage represented by those loss allowances and the size of those actual losses becomes apparent when they are compared to analogous figures at a number of commercial banks that had similarly sized portfolios of non-MSLP loans.[13] During 2023, these banks had loan portfolios ranging from approximately $16,005,325,000 to $17,587,254,000. The percentage of these banks' portfolios represented by loan loss allowances (representing anticipated losses) during 2023 ranged from 0.95 percent to 1.35 percent. By the end of 2023, the MSLP's loan loss allowance had dropped to $820,000,000 (from a peak of $2,400,000,000). Yet, this loan loss allowance still represented 4.99 percent of the original outstanding principal—nearly five times the rate of roughly comparable non-MSLP bank portfolios.[14]

Likewise, the actual losses that these banks suffered during 2023 in similarly sized portfolios of non-MSLP loans were substantially smaller than those that the MSLP program suffered during that calendar year. The net charge offs that the banks suffered (representing charge offs against which recoveries were set off) ranged from $7,182,000 to $62,773,000 (from 0.04 to 0.37 percent of the portfolio). The MSLP's 2023 actual loss of $469,000,000 is substantially larger in actual size and expressed as a percentage (2.85 percent) of the original outstanding principal.

While defaults or losses certainly do not necessarily indicate fraud, the existence of significantly higher levels of loss suggests the high likelihood of significantly higher levels of borrower fraud. At a minimum, these comparisons strongly suggest that lending banks failed to take sufficient steps to ensure the creditworthiness of many MSLP borrowers.

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[13] The data about these banks was available through the Board of Governors of the Federal Reserve System based on reports as of September 30, 2023, as well as reports available through Federal Financial Institutions Examination Council as of December 31, 2023. A chart setting forth the identity of the banks and some of the relevant data is attached to this report at Appendix B. Two of the banks—City National Bank of Florida and Arvest Bank—included one or more MSLP loans in their loan portfolios. The small amount of the portfolios represented by those MSLP loans does not affect the analysis in the text above and, in any case, makes the comparison even more significant.

[14] The conclusions here are similar to those set forth by SIGPR's auditors in their interim report dated May 12, 2023, which is available at https://www.sigpr.gov/sites/sigpr/files/2023-05/Audit_of_the_Effects_the_MSLPs_Loan_Losses_Have_on_Treasurys_Investment_in_the_Program--FINAL.pdf.

Lessons Learned: Structural Aspects of the Main Street Lending Program that Increased the Risk of Fraud

SIGPR believes that certain structural aspects of the Main Street Lending Program created a set of circumstances that increased the risk of fraud committed by MSLP borrowers. The specific features of the MSLP program that heightened these risks are (1) the very limited exposure that lenders retained after the SPV's purchase of 95 percent participation; (2) the limited obligations placed on lender banks in terms of vetting borrowers for the MSLP program; and (3) the extent to which the SPV played no role whatsoever in assessing the creditworthiness of MSLP borrowers. While none of these program features taken alone posed heightened risks of fraud, the combination and interplay among them appears to have done so.

As the examples below demonstrate, lending banks would recover a sufficient amount from fees and interest such that they could break even—that is, suffer no losses whatsoever—even if a large number of their MSLP loans went into default. In terms of the eligibility of borrowers—relating, for example, to the existence of the company, its solvency, and the type of business in which it was engaged—lending banks had minimal obligations. Indeed, lending banks had no obligation to ensure that their MSLP borrowers complied with eligibility rules. And while the lending bank was obligated to perform its customary underwriting as to the creditworthiness of its MSLP borrowers, the SPV did little to ensure that lending banks adequately performed this function.

Moreover, other than the lenders relying on borrower certifications, and the SPV relying on lender certifications, there was little oversight by the SPV, FRBB or the Board. To put it simply, because the lending banks had very little to lose, they had substantially less incentive to be diligent about ensuring that borrowers were not likely to default on MSLP loans, and there was no entity charged with ensuring that lending banks did, in fact, guard against fraud. While the borrower and lender certifications were good tools for pursuing those who were later determined to have committed fraud, they may not have been sufficient safeguards against those intending to commit fraud at the time when the loans were made.

For example, if a lending bank made a $1,000,000 MSLP loan, it sold $950,000 of the loan to the SPV and retained $50,000 of the loan on its own books. The lending bank would receive an origination fee of 100 basis points (that is, one percent), which would total $10,000. If divided equally over the period of five years, that $10,000 one-time loan origination fee represents a return of 4 percent per year.

The lending bank would receive servicing fees paid annually totaling $11,875 assuming the loan did not default and was fully paid at maturity. (The servicing fee was equal to one-quarter percent of the purchased participation – that is 0.0025 multiplied by $950,000.) This servicing fee represented an additional return of 4.75 percent per year with regard to the portion of the loan retained by the lending bank.

In addition, assuming LIBOR remained at one percent,[15] the lending bank would also receive four percent interest on the five percent of the loan it retained. That interest would be calculated as follows:

Year	Interest Paid to Lender	Calculation of Interest Paid
Year 1	$ 0	No interest was due in Year 1. Rather, interest of $2,000 (4 percent of $50,000) would be capitalized—that is, added to the principal due. That portion of the principal due to the lending bank at the end of Year 1 would be $52,000 .
Year 2	$ 2,080	Lender would receive 4 percent interest on $52,000 principal balance at the end of Year 1.
Year 3	$ 2,080	Assuming the 15 percent principal payment was made on the last day of Year 3, lender would receive 4 percent interest on $52,000 principal due to the lending bank at the end of Year 2.
Year 4	$ 1,765	Assuming the 15 percent principal payment was made on the last day of Year 4, lender would receive 4 percent interest on $44,125 principal due to the lending bank at the end of Year 3.
Year 5	$ 1,450	Assuming the 70 percent principal payment was made on the last day of Year 5, lender would receive 4 percent interest on $36,250 principal due to the lending bank at the end of Year 3.
Total Interest to Lender:	$ 7,375	

That would, of course, result in an additional 4 percent return per year.[16]

Accordingly, in this example, the economic return to a lending bank on its retained portion of a $1,000,000 loan that was repaid in full on schedule would total $29,250. This represents a 12.75 percent total return (4 percent from the origination fee, 4.75 percent from the servicing agreement, and 4 percent from interest (***plus*** any increase in LIBOR above one percent).[17]

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[15] Between October and December 2020, when most MSLP loans were made, LIBOR was between .081 and .083 percent. (*See* https://www.global-rates.com/en/interest-rates/libor/american-dollar/2023.aspx.) Of course, to the extent that the basis for the applicable interest rate (whether LIBOR, SOFR or otherwise) has exceeded the one percent rate we assumed in the example in the text for most of the life of MSLP loans, the example actually underestimates the return to a lending bank. SOFR is currently over 5 percent. (*See* https://www.newyorkfed.org/markets/reference-rates/sofr.)

[16]Interest that accrues during the first year of an MSLP loan was not due and payable, but instead was capitalized—that is, added to the outstanding balance of the loan. As a result, by the end of the first year, the outstanding balance included the interest that accrued in that first year. However, the interest on MSLP loans did not otherwise compound.

[17] The return on such a loan would be smaller if a borrower prepaid some or all of the principal because it would reduce the amount of interest due (if the outstanding principal were smaller) or could retire the loan as fully repaid before the full 5-year life of the loan. On the other hand, to the extent that the basis for the

In contrast, if no payments ever were made on the loan (and no collateral ever was collected), then a lending bank ultimately would lose $28,125 of its investment of $50,000 (after collecting $10,000 in the loan origination fee from the borrower, and $11,875 in the loan servicing fee from the FRBB).[18]

These figures are relatively rough approximations but are nevertheless instructive. A lending bank that made one MSLP loan that defaulted with no payments of interest or principal and one MSLP loan that was fully repaid at maturity would come out ahead: It would lose $28,125 on the defaulted loan but would make $29,250 on the compliant loan. In short, in order to make a profit on its portfolio of MSLP loans, a lending bank needed only half of those loans not to default. This unquestionably had the potential to make lending banks more willing to make MSLP loans to borrowers who were less creditworthy than the banks might have otherwise required.[19]

SIGPR believes that it is no coincidence that the higher default rates (which may reflect higher rates of fraud) occurred in a program structured the way the MSLP is. Indeed, it is clear that the SPV anticipated higher rates of default than those found in commercial lending; that explains why the loan loss allowance set at the very beginning of the program represented 14.6 percent of the outstanding principal—many multiples of the rate found in non-MSLP portfolios. The critical question is why that was the case.

During its investigations, SIGPR discovered a number of factual scenarios that further reflected the ways in which the structure of the Main Street program failed to protect adequately against borrower fraud. For example, in one instance, a lending bank denied an MSLP loan to a borrower because its EBITDA[20]—which the Main Street program used to determine the amount of permissible loans—was too low, but then granted the loan to that same borrower based on a different EBITDA calculation. In another investigation, SIGPR determined that a lending bank had cut ties with two of its directors after learning that the two directors controlled an entity that purchased a loan made by that lending bank, but the lending bank still gave an MSLP loan to an entity it knew was controlled by two other directors of the lending bank. In yet another instance, a lending bank made an MSLP loan to one borrower with knowledge that the borrower would use that money to repay a separate commercial loan that that lending bank had made to a different entity controlled by the same individuals as the MSLP borrower. The

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applicable interest rate indeed substantially exceeded 1 percent during the life of most MSLP loans, that fact has resulted in increased returns to the lending banks for those loans.

[18] It is our understanding that, in the event of a default, a lending bank would continue to collect its servicing fee each year as it assisted with efforts to collect the loan. The statement that a lending bank would collect all of the servicing fees even in the event of a default assumes that those efforts continued up to the full maturity date of the loan.

[19] Similar analysis of MSLP loans under $250,000 yields even more extreme conclusions due to the higher fees (on a percentage basis) that lending banks received for those loans. If a lending bank made 8 MSLP loans of $200,000 that defaulted, it would still break approximately even if it made a single MSLP loan of $200,000 that was fully paid at maturity. As it happens, only 12 MSLP loans were made in amounts less than $250,000, and no lender made more than two of them. Nevertheless, this analysis corroborates the way in which the fee structure gave lending banks significantly diminished incentives to take greater care with MSLP loans.

[20] EBITDA stands for earnings before interest, taxes, depreciation, and amortization, and is an alternative measure of profitability to net income.

bank did so despite language in a number of publications associated with the loan program that stated that MSLP loans were not intended to shift the risk of existing loans onto the FRBB or the Treasury.

SIGPR believes that a higher risk of fraud was inevitable in a system in which lending banks had little “skin in the game” and few obligations to conduct genuine due diligence of the type they likely perform with respect to non-MSLP loans. The very small portion of the loans that MSLP lending banks retained (5 percent), together with the fees the banks earned for origination and servicing, meant that a lending bank could make a good profit on a successful MSLP loan but would lose very little if such loans went into default. This gave banks insufficient incentive to look critically at the background and creditworthiness of MSLP borrowers. SIGPR’s investigations have revealed that, in many cases, lending banks extended MSLP loans to borrowers who were not existing customers. In those case, the banks knew very little about their borrowers. While the MSLP rules required lending banks to undertake the same “Know Your Customer” and underwriting that they customarily performed, there was little or no oversight to enforce compliance with those obligations. And it appears that, in many cases, compliance with these obligations was incomplete or entirely absent.

It is important to note that SIGPR does not claim to be able to identify a specific percentage of participation that would eliminate the higher risk of fraud we discuss in this report. The point is, however, that 5 percent appears to have been too little.

One possibility would be to link the level of the SPV’s participation to a lending bank’s existing familiarity with the prospective borrower. It could be that a bank would not be permitted to make a loan in a future program to a borrower with whom the lending bank does not have pre-existing familiarity. An alternative could be that the level of participation could be adjusted based on whether or not the borrower is already known to the lending bank. A different alternative could be to impose greater due diligence obligations on lending banks in the case of borrowers with whom the lending bank has no pre-existing familiarity. Any of these changes would serve to increase the incentive of lending banks to make loans backed up by taxpayer money only to borrowers that the lending banks have appropriately determined to be eligible and creditworthy. Such a change would certainly serve to reduce waste, fraud and abuse in future loan and assistance programs by the federal government.